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No. 410

Supreme Court of the United States

October Term, 1944

OWEN N. PRICE, Trustee for Bondholders of The Western Tool & Manufacturing Co., and ROY MASSENA, E. J. PRICE, W. D. HOLLISTER and W. T. KETTERING, Bondholders' Protective Committee for Holders of Bonds of The Western Tool & Manufacturing Co.

Petitioners,

vs.

JAMES G. GURNEY, Individually and on Behalf of Other Shareholders of The Western Tool & Manufacturing Co., and THE WESTERN TOOL & MANUFACTURING COMPANY, a Corporation.

Respondents.

PETITIONERS' ANSWER BRIEF TO MEMORANDUM OF COUNSEL FOR SECURITIES AND EXCHANGE COMMISSION

WM. W. KEIFER,
HORACE S. KEIFER,
512 M & M Building,
Springfield, Ohio,
Counsel for Petitioners.

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PETITIONERS' ANSWER BRIEF TO MEMORANDUM OF COUNSEL FOR SECURITIES AND EXCHANGE COMMISSION.

This Brief is filed by leave of court in answer to the Memorandum of Counsel for Securities and Exchange Commission filed January 12, 1945, the day of the oral argument.

We note in the first place (pp. 4, 14-15) that Counsel for the SEC are concerned with only one question in this case and that is whether stockholders can under Chapter X file a petition "for and in the name of their corporation" for reorganization as a derivative right. Thus, if SEC Counsel are correct, the questions of fact arising as to (1) whether there was bad faith or wrongful conduct on the part of the directors, (2) whether there was or is reasonable prospect of a reorganization, and (3) whether the

prior pending proceeding in the state court is not sufficient, are still to be determined.

DOCTRINE OF DERIVATIVE ACTIONS NOT APPLICABLE.

We of course agree with much in Counsel's Memorandum, first as to the nature and use of derivative actions and secondly as to the need of protection for the public (scattered numerous stockholders) against crimes of management and also that SEC has rendered valuable service in the latter field. This is an able and interesting discussion but not applicable here to this small corporation ($112,050.00 par value stock, most if not all of the value of which has been lost, $73,100.00 par value of bonds, and *no general creditors*).

That it is not applicable is clear in view of the fact that Chapter X was enacted for the reorganization of "corporations with complicated debt structures and many stockholders" (*Sec. & Ex. Com.* v. *U. S. R. & Co.*, 310 U. S. (434) 447.) and not for small concerns whose owners, (bondholders and stockholders), can and must adjust their respective rights by dealing directly with each other. Chapter X does not mean that one class of investors is to be favored over another and stipulated rights changed. The stockholders here have had ample opportunity over a long period of time to protect themselves and the bondholders have over the same long period of time deferred their rights to realize on their mortgage security, (the first default having been in 1923 or earlier and the last maturity date of the principal of the bonds being in 1931, R. 52). Why should now the bondholders be penalized by further delay, reorganization machinery and expense, when the only possible result is the sale of the mortgaged property to satisfy the debt? Of course, the stockholders through the corporation may redeem the property by directly paying or settling with the holders of the

mortgage, but this calls for no reorganization under Chapter X.

Counsel for the SEC (p. 3 note 4) are ingenuous enough to admit that the SEC had refused a stockholder's attempt to file derivatively on behalf of the corporation a plan under Sec. 11 (e) of the Public Utilities Holding Act of 1935 for the divestment of control, etc. It will be noted that this process is in fact a reorganization of a corporation, perhaps a drastic one. Therefore, such a holding is rather definite authority against the proposition of Counsel in reference to Chapter X.

REORGANIZATION NOT THE SAME AS LIQUIDATION.

Counsel argue (p. 9) that since stockholders have, under certain circumstances, the right to insist that the management institute proceedings to wind up their corporation, as a corollary, they have a right to demand that the management institute reorganization proceedings when the corporation is in need of financial rehabilitation. No doubt the directors of a corporation have a legal duty to wind up a corporation when the objects of a corporation have failed so that it no longer is able to continue operation, but we submit that when the question of continuing or liquidating is whether it is wise or good policy to continue, then the directors will exercise business judgment and cannot be forced by the stockholders to take either course. This relegates us to the original question whether these directors had a legal duty to petition for reorganization.

MANDATORY INJUNCTION.

Further characterizing the claim that directors may be required to file a reorganization proceeding is the statement (p. 10) that in case a derivative petition cannot be filed a

stockholder would be forced to secure a mandatory injunction against the directors. A suit for such mandatory injunction we submit would be anomalous and unheard of.

WHO CAN ACT FOR CORPORATION.

Counsel for SEC seem to argue (p. 3) that since Chapter X does not specify who shall act for the corporation in filing the petition, therefore a stockholder may. It is of course left to the rule of general corporation law and that is, as we pointed out in our Brief, (pp. 13-14), that only the directors can authorize such proceeding. And this court has recently held, (*Voeller* v. *Neilston Warehouse Co.* 311 U. S. 531, 536-7), as to an Ohio corporation that the corporation acts through its directors and that the stockholders entrust the affairs of the corporation to the directors.

AS TO LIMITATIONS AND SAFEGUARDS.

It is rather significant that Counsel, in proposing the plan for stockholders to file a petition under Chapter X, admit that there should be "limitations and safeguards necessary to prevent possible abuse by stockholders of the right." (pp. 9, 13). Passing for the present that it is judicial legislation that is thus proposed, we venture to suggest that this clearly shows no such right exists under the statute. If Counsel recognize that definite "limitations and safeguards" must be applied, it is apparent that legislation is required to create the right as well as impose the limitations and safeguards.

We note here that Counsel (p. 14) include among the "limitations and safeguards" the requirement (of Sec. 146 (3) that there be a reasonable expectation of effecting a reorganization and (Sec. 146 (4)) that a prior pending proceeding will not best subserve. This recognition fully con-

firms our contention that when it appears that these two requirements are not met the proceeding must fail.

(We take it (p. 17 Note 14) that Counsel are not in harmony with the Marine Harbor case. An attempt is made to show that appraisement and sale of property in a foreclosure case are not adequate and that the Marine Harbor case applied only where the prior pending case was under a New York statute. The report of that case does not so indicate.)

PRELIMINARY HEARING OF DERIVATIVE PETITION TO BE REQUIRED.

A significant further safeguard suggested by counsel (pp. 15-16) is that "a preliminary hearing is necessary in every case before the court approves a derivative petition." The statute has provided for a preliminary hearing before a petition is approved (Secs. 141-144) and Counsel propose another preliminary hearing to determine whether a derivative petition is proper. Thus there is to be a hearing preliminary to a preliminary hearing. The further suggestion is made (p. 17) that there be opportunity for answer and hearing on this question. This of course would be different from and anterior to the answer and hearing provided for in Secs. 136-144. This likewise is new law and procedure. Such contention only emphasizes our claim that the statute does not provide for or contemplate any such procedure.

Finally, we cannot agree with some expressions in the SEC Memorandum. "Dismembering of a corporation through further steps by way of foreclosure" (p. 10) and "inequitable foreclosures" (p. 12) are expressions that attempt to characterize a foreclosure suit as something very wicked. A suit to subject mortgaged property to the pay-

ment of the debt secured thereby is a suit in equity and therefore would be an "inequitable" equity, according to Counsel's characterization. We see nothing unrighteous or inequitable in applying pledged property to the payment of an obligation incurred and induced on the strength of the pledge, especially if the holder of the obligation has held off enforcing his claim for twenty years.

In all the contentions for the reorganization proceeding the rights of the mortgage bondholders are completely ignored.

CONCLUSION.

We submit there is no room in Chapter X of the Bankruptcy Act for a derivative petition. It would be inconsistent with Sec. 126 and require procedure and hearings nowhere provided for. If there are arguments in favor of such law and procedure they should be submitted to Congress and not to the courts.

But if there is a right to file a derivative petition, still no case has been made here on the facts, and, what is even more clear, "good faith" within the meaning of Sec. 146 (3) and (4), is lacking. That it is unreasonble to expect a plan of reorganization to be effected cannot be questioned, nor that the prior pending proceeding will not best subserve. When absence of "good faith" appears at any stage, the proceeding should be dismissed.

Respectfully submitted,

WM. W. KEIFER,
HORACE S. KEIFER,
Counsel for Petitioners.